SEP 16
MICHAEL RODAK,

No. 73-1652

IN THE

Supreme Court of the United States

October Term, 1974

YOUR HOST, INC., *et al.*,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF FOR PETITIONERS

ALBRECHT, MAGUIRE, HEFFERN
& GREGG,
Attorneys for Petitioners,
2110 Main Place Tower,
Buffalo, New York 14202.

Of Counsel:
RALPH J. GREGG,
GEORGE M. ZIMMERMANN.

BATAVIA TIMES, APPELLATE COURT PRINTERS
A. GERALD KLEPS, REPRESENTATIVE
BATAVIA, N. Y. 14020
716-343-0457

INDEX.

PAGE

Purpose for use of § 482 tacitly admitted 1

Response attempts to confuse the facts and issues 2

As to the § 482 Issues 2

As to the Petitioners' Contentions and the facts 3

Conclusion 8

CITATIONS.

Advance Machinery Exch. v. Commissioner, 196 F. 2d 1006, cert. den. 344 U.S. 835 ..... 4, 5

Automobile Club v. Commissioner, 355 U.S. 180 7

Commissioner v. Chelsea Products, Inc., 197 F. 2d 620 4, 5

Hamburger's York Road, Inc. v. C.I.R., 41 T.C. 821 .. 5

STATUTES.

§ 269 ..... 2, 3, 5

§ 482 ..... 1, 2, 3, 4, 5

IN THE

Supreme Court of the United States

No. 73-1652

October Term, 1974

YOUR HOST, INC., *et al.*,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF FOR PETITIONERS

Purpose for use of § 482 tacitly admitted

The real significance of the Response filed by the Solicitor General is his tacit admission that the only reason the Commissioner consolidated the income of these corporations under § 482 was to disallow surtax exemptions by the adroit trick of putting all of the income of fourteen of them on the tax returns of the first two corporations formed by Wesson and Durrenberger.

The Solicitor General requested an extension of time to confer with the Internal Revenue Service about certain of the contentions in the Petition. If he conferred about this, he found that the revenue agents had candidly explained to the petitioners that this was exactly what they were doing.

In defense of this action, he argues that "Congress specifically contemplated the possibility" that revenue agents would use §§ 482 and 269 interchangeably, quoting two sentences from a Senate Committee Report which were never intended to be interpreted in this cavalier fashion (Response, p. 12).

Response attempts to confuse the facts and issues

Otherwise, in what purports to be a Response to the Petition, the Solicitor General has misconstrued, misstated, twisted, distorted, and even tortured the issues, the petitioners' contentions, the facts and the decisions of the Circuit Courts for no apparent reason other than to confuse and mislead this Court.

As to the Section 482 Issue

1. This is immediately apparent from the Solicitor General's version of the issue. The way he would have it is whether the Commissioner may use § 482 "to reallocate all of the net income of one commonly controlled corporation to another such corporation". (Response, pp. 1-2).

This is a simplistic straw man. Surely he can if the owner arbitrarily shifts income from a genuine corporation that earns it to a phony or sham corporation that doesn't.

But that is neither the issue nor the facts of this case. Here, there was no shifting or distortion of income of any description by the owners to be reallocated under any Section of the Code. It was the Commissioner who arbitrarily shifted the income of thirteen healthy and viable, taxable entities to a fourteenth (and of the fifteenth to a sixteenth) so that he could tax all but the first $25,000.00 of the total at 48% and thereby deprive fourteen corporations of their right to have up to $25,000.00 apiece taxed to 22%.

2. The Solicitor General repeated this ploy by rephrasing the second question as though it were a mere coincidence that the Commissioner's 100% allocation deprived fourteen of sixteen corporations of their surtax exemptions (Response, p. 2).

It was not a mere coincidence. The revenue agents candidly explained that this was their reason for using § 482—not to reallocate income shifted by the owner—but to *indirectly* disallow surtax exemptions and, if that strategy did not succeed, to disallow their surtax exemptions *directly* under § 269.

As to the Petitioners Contentions and the facts

The Solicitor General adheres to the same pattern throughout his Brief—subtly misstating the petitioners' contentions to provide himself with easy answers and to mislead and confuse the Court. The major misstatements are discussed below:

1. Petitioners *did not* "urge that the Commissioner is never authorized to allocate all of the net income of one corporation to another because the result would be equivalent to the result achieved by the filing of a consolidated return" (Response, p. 6).

The Solicitor General said this so that he could cite *Advance Machinery Exch. v. Commissioner*, 196 F. 2d 1006, cert. den., 344 U.S. 835, for the proposition that this interpretation would permit "the most flagrant evasion by the arbitrary shifting of income" (Response, p. 7); thereby creating the false impression that there was some evidence of evasion here.

Advance Machinery was a case in which:

> "There was evidence that large numbers of purchase invoices had been altered to attribute them to one or another of these taxpayers and that these changes were made without any set policy to indicate that there was any motive in doing so other than to divert income from the petitioner."
>
> "The two (father and son) operated the business . . . in such a way that the net profit of each (of the four businesses) could be manipulated as they saw fit". 196 F. 2d 1006, at 1008.

The Second Circuit in *Advance Machinery* did not, as the Solicitor General claims (Response, p. 6) reject the decision of the Third Circuit in *Commissioner v. Chelsea Products, Inc.*, 197 F. 2d 620. On the contrary, it said:

> "This is consistent with the manner in which § 45 is applicable; the reallocation of income thereunder being based not on a disregard of taxable entities but on the *correction of business entries*". 196 F. 2d 1006, 1010.

Chelsea Products stands solidly for the proposition for which the petitioners actually contend—that the Commissioner may not disregard corporate entities and use § 482 to consolidate the net income of corporations which were formed for sound business reasons, conducted their own businesses and earned their own income.

2. The Solicitor General creates the inference that the Commissioner "examined transactions between (these) controlled taxable entities in order to determine whether they would have been concluded in an arms-length negotiation between strangers and made a reallocation where they failed to meet that standard". (Response, p. 6). This is false.

The revenue agents didn't even inquire into intercorporate transactions. They said that Durrenberger had the benefit of too many surtax exemptions; that *Hamburger's York Road* had shown them the way to nullify surtax exemptions by using § 482 instead of § 269; but that they would also set up deficiencies under § 269 anyway to protect the revenues.

3. The petitioners *did not,* as the Solicitor General claims (Response, p. 7), cite *Commissioner v. Chelsea Products, Inc., supra,* for the proposition that "the Commissioner cannot as a matter of law allocate all of a corporation s income under § 482". Of course he can if a common owner, as in *Advance Machinery,* arbitrarily diverts income from a corporation that earns it to dummy or sham corporations to evade taxes.

There is no conflict among the Circuits as to this question. But a very serious conflict has arisen among the Circuits, as explained in the petition, where the separate corporations actually earn and report their own income.

4. The Solicitor General's version of the income and expense of Chef Foods, Inc. appearing on Pages 8 and 9 of his Response is absolutely untrue. The Solicitor General would have the Court believe that Chef Foods, Inc. had annual receipts averaging $160,000.00 for the four years of issue but that it spent only $179.00 for repairs and $160.00

for supplies during that period, leaving it with a net profit in the excess of $159,900.00 annually. This is not only absurd but grossly false and deceptive.

The exhibits from which the Solicitor General purports to extract this information show that Chef Foods paid out an average of $100,105.00 a year for inventories and an average of $25,829.75 a year for salaries and wages, office and administration and car expense, rent, real estate taxes, sales taxes, utilities, insurance, licenses and for depreciation on buildings and equipment, leaving an average net profit of only $37,866.75 per annum.

It is also undisputed in the record that Chef Foods, Inc. paid its own bills and earned its own income; that Your Host, Inc. operated retail restaurants and nothing more, did not engage in the cigarette vending machine business, had no interest in the real estate from which Chef Foods derived over $30,000.00 of its gross income and did absolutely nothing to earn the income of Chef Foods, Inc.; that there was no basis for allocating the income of Chef Foods, Inc. to Your Host, Inc. and that Your Host, Inc. was chosen only because it was Durrenberger's first corporation.

5. The Solicitor General's defense of the 100% allocation of the income of Your Host Bakery, Inc. to Sher-Del Foods, Inc. demonstrates the validity of the petitioners contentions—that the Circuit Courts are confused as to the rule to be applied where a 100% allocation is obviously arbitrary and inappropriate and a remand would afford the taxpayer an opportunity to prove the exact dollar amount of the allocation the Court defined as being the proper one.

Here the finding was that Sher-Del Foods, Inc. had not charged Your Host Bakery, Inc. for billing and delivery

expense. The Solicitor General defends the Second Circuit in denying the petitioner the opportunity, on remand, to prove the exact dollar amount. Both are in disagreement with the Supreme Court and the Fifth and Seventh Circuits, the Solicitor General's wordy protestations (Response, pp. 10-11) to the contrary notwithstanding.

6. The petitioners *did not* claim that it is a violation of due process if the Commissioner reverses determinations made by his agents in prior audits (Response, p. 12).

The violation of due process described on Pages 12-14 of the petition was not considered in Automobile Club v. Commissioner, 355 U.S. 180, which involved the correction by the Commissioner of "a mistake of law" by a retroactive ruling.

Here the Commissioner and the Trial Court deprived the taxpayers of a fair trial of the issues, the Commissioner by raising the issue for the first time after everybody was dead and the facts were buried in history and the Trial Court by refusing to hear any evidence that might show that the Commissioner and his agents were being unreasonable, arbitrary and unfair.

Conclusion

The petition for a writ of certiorari should be granted.

Respectfully submitted,

ALBRECHT, MAGUIRE, HEFFERN
& GREGG,
Attorneys for Petitioners,
2110 Main Place Tower,
Buffalo, New York 14202.

Dated: September 9, 1974.

Of Counsel:
RALPH J. GREGG,
GEORGE M. ZIMMERMANN.